

A new drama is being played out in Asia, to considerable applause from an international audience. However, there is a need to respond to the wider stage and the new players.

A large amount of Asian savings are placed outside the region and then reinvested here, rather than being intermediated in our own markets. Recent meetings between Asian central banks have taken the first steps towards the co-operation that may change this.

Introduction

I am very honoured to be invited to address the French Business Association of Hong Kong, a very significant part of our business community. Since I have been invited back to address you, I presume you think that I may have something important to say. I shall therefore take this opportunity to reflect on a subject that I think is important. It has been on my mind for some time, and I think it has important implications for Hong Kong and the Asian Region.

Just under 30 years ago, the renowned Swedish economist, Gunnar Myrdal, wrote a monumental book called *Asian Drama – an Enquiry into the Poverty of Nations*. It was mainly on South Asia. Some of its conclusions may be out of date, but its evaluation of the cultural, social, religious and political dimensions of economic development remain as refreshing as the day it was written. Myrdal used the word “drama” wisely, because a drama can be a success, a comedy or a tragedy, depending on how events unfold. He also pointed to the need, for the drama to be a success, to change institutions, with modernising values; and he put forward the hypothesis that “often it is not more difficult, but easier, to cause a big change rapidly than a small change gradually”. Borrowing rather shamelessly these themes, I would like to talk about the New Asian Drama, and to share with you my views as to what changes or emphases are necessary in the monetary area so as to assist in making that new drama a resounding success. I hope this is of interest to you, for, by being in Hong Kong, you are very much essential actors in that drama. Indeed, Myrdal said that:

“To some degree all of us are participants in this drama. It is as if the stage, set for Asia, were enlarged and drew upon itself

the entire world, so that no one could be merely a spectator.”

The Asian Backdrop

In broad terms, the East Asian Region¹ has been the fastest growing region in the world, achieving since 1960 one and a half times the rate of growth of the world average. Per capita income in the Region has more than tripled over this period. In 1994 the Region accounted for almost a third of the world’s population, a quarter of world trade and almost US\$500 billion of the world’s foreign exchange reserves, approaching half of the global total. Nine out of the top 20 exporting economies in the world are in the Region. So are eight of the top 20 stock markets and they account for about a third of market capitalisation, as against 40% for American exchanges and about a quarter for European bourses (Table 1).

Based on World Bank forecasts the Region could grow at an average annual rate of over 6% between 1994 and 2004, compared with around 5% for the developing countries and a little over 3% for the world as a whole.

The Region has been able to sustain high growth with stability because of the following key factors:

- Sound fundamentals;
- Strong private domestic investments, supported by public investments in human and physical infrastructure, that were the main engines of growth;
- Sound fiscal policies – with governments setting an example in fiscal discipline, that also encouraged high levels of private and national savings;

* This is the text of a speech by Joseph Yam, CBE, Chief Executive of the HKMA to the French Business Association on 19 December 1995.

¹ Unless otherwise specified, East Asia is defined here to include Australia, China, Hong Kong, Indonesia, Japan, Malaysia, New Zealand, the Philippines, Singapore, South Korea, Taiwan and Thailand; being the main economies for which economic data are readily available.

Table 1:
The world's top 20 reserves holders, exporters and stock markets

Rank	Foreign Reserves 1995 latest position		Exports 1994		Stock Market Capitalisation * September 1995	
	Country	(US\$ bn)	Country	(US\$ bn)	Country	(US\$ bn)
1	Japan	182.0	USA	512.5	USA	5,427
2	USA	93.8	Germany	427.2	Japan	3,372
3	Taiwan	91.4	Japan	397.0	UK	1,329
4	Germany	88.4	France	235.9	Germany	568
5	China	69.8	UK	204.9	France	486
6	Singapore	67.7	Italy	189.8	Switzerland	370
7	Hong Kong	51.8	Canada	165.4	Canada	355
8	Norway	50.0	Netherlands	155.6	Hong Kong	292
9	Switzerland	38.9	Hong Kong	151.4	Netherlands	275
10	UK	38.0	China	121.0	South Africa	250
11	Netherlands	37.3	Singapore	96.8	Australia	245
12	Italy	36.3	South Korea	96.0	Malaysia	212
13	Thailand	35.0	Taiwan	92.8	South Korea	199
14	Spain	34.8	Spain	73.3	Italy	184
15	France	31.8	Switzerland	66.2	Sweden	180
16	South Korea	31.2	Sweden	61.3	Spain	179
17	Malaysia	26.2	Malaysia	58.8	Taiwan	171
18	Sweden	26.2	Australia	47.6	Brazil	166
19	Austria	23.2	Thailand	45.3	Thailand	142
20	India	20.1	Austria	45.2	Singapore	136

* Major market in country

Main Sources: International Monetary Fund *International Financial Statistics*, November 1995,

Federation Internationale des Bourses de Valuers, *Monthly Statistics* September 1995

- An openness to new technology, world competition and trade. In Asia, the two free ports of Hong Kong and Singapore were both demonstration models of the benefits of free trade and competition, as well as the showcases of world class products and services to Asia;
- Attention to equity – the fruits of success have been by and large fairly widely shared, resulting in broad social stability. Agricultural and land reform improved food production and encouraged savings that financed industrialisation, similar to the Industrial Revolution in Europe.
- Last but not least, growth was built on sound money. By focusing on fiscal and monetary discipline, East Asia has

assiduously avoided the hyperinflation that has plagued development in Latin America, Africa and Central and Eastern Europe.

All this is very encouraging, so much so that many now assume that the drama will turn out to be a miracle. However, as the French economist, Raymond Aron, said, "Optimism [alone] is a sure sign of an error in thinking". In my opinion, this outcome cannot be taken for granted. Many challenges lie ahead, such as political risks, ecology, resource constraints, over-population, population aging, and trade and other conflicts that could shatter the Asian dream. I am neither a fortune teller nor a political scientist, but a realistic central banker. I can only give advice on money. From that perspective, the realisation of the East Asian miracle would I think require continued adherence to the principle of sound money. This necessitates,

I would argue, considerable efforts on the part of the Asian central banks in monetary co-operation.

Changing of the Scene

Almost exactly a year ago last December, the Mexican financial crisis sent a tremor of seismic proportions around the world. The dangers of a Mexican default not only spoilt the spirit and evaporated the Christmas bonuses of many fund managers in Wall Street, but also rippled across the Pacific. On 12 January this year, we saw the first shock wave of speculation against the freely convertible Asian currencies. As you know, the speculation was promptly beaten back and life quickly returned to normal.

The Mexican episode was a waking bell to Asian central bankers, long used to stability in their markets. Thus they began to wonder: what has changed for Asian monetary stability? What has remained the same? What needs to change? Or is it merely a case of, using the French expression, "*plus ça change, plus c'est la même chose*" – the more things change, the more they are the same? Let us take a look.

First, what has definitely changed is that globalisation of financial markets is already at hand. There was an old saying that when America sneezes, Japan catches a cold and the rest of Asia gets pneumonia. However, the fact that Mexico can catch a cold and America can sneeze and the whole world feels the shivers is something new. With open capital accounts, and significant foreign direct and portfolio investments pouring into Asia, Asian currencies have become susceptible to the global ebb and flow of financial resources.

Second, the players have changed. The commercial bankers, who have always had branches and offices in Asia, understand the Region well. On the other hand, new actors have appeared on centre stage in the last five years. Securities houses, pension and mutual funds, investment banks and also hedge funds have appeared in Asian markets, bringing with them derivative specialists, international lawyers, rating agencies, information technologists and the supporting industries that have transformed Asian markets. They have introduced new ideas, new technology, but also new risks. Mr Nick Leeson was an example of a risky actor.

Third, in the face of global markets, there was a widespread belief, rightly or wrongly, that the ability of central banks to stabilise exchange rates seemed to have slipped from their grasp. The ERM crisis in 1992, when hedge funds reputedly gained billions by speculating against several European currencies, provided (inconclusive) evidence of this. With a daily turnover of US\$1.2 trillion, it was felt that markets were too big for the central banks to manage. Indeed, more than one book has been written about the predatory behaviour of hedge funds, depicted by one author as Vandals, eyeing greedily the hoard of foreign exchange reserves carefully guarded by the central banks. Frankly speaking, the Asian central banks, used to stability in their own markets, watched with amazement as the dollar-yen rate moved 20% down and up between February and August this year. Fortunately, there was little further turbulence in the Asian currencies.

What has remained the same? Obviously, the sound fundamentals and the Asian commitment to monetary and financial stability have not changed. In the January episode the markets quickly became aware that the fundamentals in Asia were very different from those in Latin America. Even though some Asian countries ran a slightly higher current account deficit, these arose mainly from the need to import capital goods to increase overall productivity.

What has also remained the same is that, as lender of last resort, central banks are in a position to dictate terms when eventually they are asked to lend domestic currencies directly or indirectly to speculators shorting their currencies. They can inflict considerable pain on speculators and those financial institutions that provided funding to the speculators. But admittedly some central bankers' ability to persevere are still influenced by the political clout of innocent borrowers who have also to bear the pain of high interest rates along with the speculators.

What needs to change? In the aftermath of the January speculation, I convened an informal meeting of several central banks that felt some of the speculative activity. There was an immediate agreement that it would be useful to exchange information on market activities, to monitor the markets more closely, to share knowledge and techniques on overall financial market supervision,

and to immunise or raise the pain tolerance levels of the economy in case it became necessary to inflict pain on the speculators. Out of this meeting, and other regional meetings, including the one I again convened in Hong Kong last month, there evolved a clear consensus of the need for more central bank co-operation in this Region. Indeed, in a speech delivered in September, Mr Bernie Fraser, Governor of the Reserve Bank of Australia, called for the establishment of an Asian Bank for International Settlements or its equivalent, that is, a formal institution for regional monetary co-operation. This is a good example of the institutional change that Myrdal would advocate.

Converging Trends

There are further converging trends that have contributed to this realisation. First, the growth of intra-regional trade in the last decade has been exceedingly rapid. Recent studies by UNIDO suggest that Tri-polar Regionalism is fast emerging, despite the global commitment to free trade. In Europe, intra-EU trade accounted for 57% of total trade in 1994, up from 53% a decade earlier.² In North America, the corresponding proportion was 42% and for East Asia, 51%, which is a sharp increase from 40% a decade earlier. The volume of intra-regional financial transactions has therefore grown, with corresponding rapid increase in demand for financial services.

Second, to sustain the high growth in East Asia, the Region will have to commit huge levels of infrastructure investment. The World Bank estimates that between 1995-2004, the projected investment requirements (excluding the OECD economies) would be a staggering US\$1.5 trillion. If other forms of capital formation are taken into account, the investment requirement would amount to US\$8 trillion. An obvious question is where the funding for this huge investment will come from.

Third, like the OECD countries, East Asia is also aging quite fast. By 2010, the World Bank projects that 29% of the Japanese population will be over the age of 60. The rest of East Asia could reach that level by 2090. Consequently, there is need to generate the savings to provide the resources for our aged. Luckily, the savings rates of economies in this Region are the highest in the

world and much higher than OECD countries. And there is also a tendency for savings to be institutionalised. The Hong Kong Mandatory Provident Fund scheme is one example, possibly generating something in the order of 4% of GDP in savings annually. But there is a clear lack of supply of financial instruments, such as official debt, considered suitable for such institutionalised savings, ironically the result of the prudent adherence to fiscal discipline.

Fourth, although the US dollar is still the dominant currency of international transactions, accounting for 83% of daily global foreign exchange transactions in April 1995, only roughly 57% of total official holdings of foreign exchange reserves are in US dollars (Table 2). According to available IMF data on developing country reserves, the Deutschmark and Yen have increased their share from 9.8% and 6.8% respectively in 1985 to 12.3% and 8.6% by the end of 1994. A major issue that is emerging, but not fully clear, is the internationalisation of the Yen. And convertible Asian currencies are becoming more popular and liquid in foreign exchange markets. The simple question can thus be asked: to what extent should intra-Asian trade be transacted in Asian currencies?

Fifth, there is a widely held myth that I wish to dispel, which is that the East Asian Region is so dependent on inward financial flows that a sudden withdrawal would be a major shock to the system. If we look at the balance of payments picture for the Region, even excluding Japan, the current account is in fact roughly in balance. Capital inflow into the Region has largely been offset by the accumulation of official foreign currency reserves and some outflow of private sector savings.

Financial Intermediation

All these have led me to come to a conclusion about financial intermediation in Asia: that Asian financial markets are not intermediating domestic savings efficiently. A substantial part of such savings are invested outside the Region, mostly in OECD countries, while the huge infrastructural and other investment needs of the Region look, in some cases desperately, for foreign direct investment. In other words, Asian trade surpluses with the OECD countries are compensated by an increase

2 Calculated using the current 15 members for both years.

Table 2:
Currency Shares in Identified Official Holdings of Foreign Exchange Reserves
 end-year

	1985	1990	1994
<u>All countries</u>			
US dollar	55	49	57
European currencies	32	35	30
Yen	7	8	8
Other/unspecified	6	8	5
<u>Industrial countries</u>			
US dollar	50	45	52
European currencies	41	41	36
Yen	8	9	8
Other/unspecified	1	5	4
<u>Developing countries</u>			
US dollar	63	58	64
European currencies	20	22	22
Yen	7	7	9
Other/unspecified	10	13	5

Source: derived from Table I.2, *IMF Annual Report 1995*.

in financial claims on these countries, largely in the form of official reserves. This is understandable as the OECD countries have superior credit ratings, as well as very efficient and liquid markets.

Indeed the global capital recycling loop is closed when official reserves flow to the OECD countries from Asia, and the funds flow back in the form of private financial portfolio or direct investments. An unkind observer may say that the Asian central banks provided part of the liquidity to New York or London, which the hedge funds borrowed at cheap rates to play in the Asian markets.

But seriously, there is I think a perplexing anomaly in financial market activity. The Asian surpluses are placed in Triple-A markets, but their own institutions and markets are often rated single A or below. The result is that the lending is done cheaply, while the borrowing is more expensive. The Japan premium is a classic anomaly of this nature. Why should a Japanese bank buy Triple-A paper at 50 basis points below LIBOR and borrow inter-bank at 50 basis points above LIBOR? The natural question to ask then is why Asian surpluses are not lent more to finance Asian borrowers?

The answer is that Asian financial markets are in fact not geared to finance Asian development. A dealer in Hong Kong is more likely to talk to a

dealer in New York or London than to a dealer in Jakarta or Seoul. That inertia is very much still there, as evidenced by recent BIS statistics on, for example, foreign exchange turnover. Yet the ownership of the money of this world, at least in the form of official reserves, is increasingly concentrated in this Region. And helped by rating agencies, OECD credit risks are still perceived to be significantly lower, and liquidity in OECD markets is consequently higher. Dealers in this Region, therefore, continue to stay up late and pick up the phone to London and New York, notwithstanding that the payment and settlement risks of transactions between Asia and Europe and America are very high, because of the lack of delivery versus payment (DvP) and payment versus payment (PvP) across international boundaries.

Asian Monetary Co-operation

Against that sentiment, the bilateral repo agreements signed by five central banks in Hong Kong on 20 November, followed by similar agreements signed between other central banks in the Region, were a historic landmark in Asian monetary co-operation that may redress the balance. It was a small but concrete step towards building stronger Asian financial institutions and more comprehensive monetary co-operation in the Region so that the future needs of Asian savings and

investment could be met.

Towards that end, there is a shared vision that domestic financial systems require stronger and deeper stock and bond markets. They need sound banking systems and efficient and robust payment systems. They need well functioning foreign exchange and futures markets. To build these markets, they need stronger institutions (in banking, securities, and fund management), lawyers, accountants, derivatives specialists and financial technologists such as the OECD offers. These are areas where Asians have the talent to learn.

For this to happen, the Asian policy makers and central banks will have to sit down to discuss how they could help each other strengthen institutions, harmonise regulatory standards, deepen markets, and manage the risks associated with financial transactions between both Asian markets and abroad.

The global financial market is already a network of markets. The Asian financial system is not yet a network. It is a group of individual markets that are more plugged into London and New York, than with each other. For the global network and Asian network to thrive, there must be robust and homogenous connections between these markets. Asia is probably 40 years behind Europe in the level of intra-regional connectivity. It took Europe more than 20 years to reach the consensus of monetary integration, and another 15 to arrive at the Maastricht Treaty. I would not even dream of Asian monetary integration, when the Asian trend is exactly in the opposite direction. In Hong Kong and China, for example, there will be after 1997, one country, two currencies, two monetary systems, and two mutually independent central banks. The lack of policy convergence argues strongly for monetary segregation, rather than monetary union.

Asian monetary co-operation will be quite different from the American or European model. In America, the dollar is the undisputed currency of North and South America. In Europe, there is migration towards a single European currency to be named the Euro. In Asia, there will be many strong currencies, and strong markets, but this would not prevent the free flow of transactions between these markets. Technology has improved to the extent that markets can be conveniently

extended geographically through efficient and robust payment, clearing and settlement systems that are well connected to each other.

But this vision of strong Asian markets will not happen if Asian policy makers do not sit down with each other in a regular and structured manner to make this vision a reality. There is therefore a need to learn from Myrdal and build Asian institutions to serve Asian needs, and to do so quickly. The European community of central bankers have been able to influence significantly the course of monetary discussions, bank supervision and payment systems through the work at Basle. This pool of European talent has been most creative and helpful in the work towards European integration. Similar Asian organisations, such as the concept of the Asian Bank for International Settlements as suggested by Governor Bernie Fraser, would be a helpful initiative.

The Global Dimension

The development of Asian markets will not be a threat to American or European markets. The bilateral repos between Asian central banks are not in Asian securities – they are in US Treasuries. These repos help to improve US dollar liquidity in Asian time. OECD financial institutions have a major role to play in strengthening and deepening the Asian markets. Even though some may be less patient than others, Asian financial markets are irreversibly opening up to greater de-regulation and international competition.

When we had the Global Payment System Seminar in Hong Kong last month, a banker from Chicago told the central bankers present that in the area of global payment system development, they must “Lead, Follow, or Get out of the Way”. In the area of Asian financial market development, Asian central banks are clearly taking up that challenge to lead.

The road to regional co-operation will not be easy, because domestic interests are as important as regional or international interests. But I am confident that there is a growing shared vision of the need for co-operation that far outweighs the instinct for competition. Open trade has always been a win-win situation for everyone. Moreover, stability in Asian markets will contribute significantly to stability in global markets. Malaysian Deputy

Prime Minister Anwar Ibrahim said in his closing speech at the Asian Bond Market Conference in Hong Kong last June: "It is one of the ironies of the 21st century that the growing global financial markets in fact have no boundaries, but we must manage our own house properly in order that the global markets be built on strong national foundations". Thus, efforts at strengthening domestic markets contribute towards strengthening the global market.

To end again with Myrdal: "History, then, is not taken to be predetermined, but within the power of man to shape. And the drama thus conceived is not necessarily tragedy." I am confident that the New Asian Drama will not be a tragedy. I am very hopeful that it will be a resounding success. And it certainly will be an exciting one. I thank you for your patience and hope that you will play a major role in the unfolding of this drama. ☉